

Letter of Findings: 04-20110343
Sales and Use Tax
For the Years 2008 and 2009

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ISSUES

I. Sales and Use Tax—Manufacturing Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-3; IC § 6-8.1-5-1; [45 IAC 2.2-5-8](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Rhoades v. Indiana Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Indiana Dep't of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); General Motors Corp. v. Indiana Dep't. of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); Mumma Bros. Drilling Co. v. Department of Revenue, 411 N.E.2d 676 (Ind. Ct. App. 1980); Indiana Dep't. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983).

Taxpayer protests the assessment of use tax on purchases of various items of tangible personal property.

II. Sales and Use Tax—"Maintenance Agreements."

Authority: IC § 6-8.1-5-1.

Taxpayer protests the assessment of use tax on its purchases of "maintenance agreements."

III. Sales and Use Tax—Improvements to Realty.

Authority: IC § 6-2.5-3-2; IC § 6-8.1-5-1; [45 IAC 2.2-3-4](#); [45 IAC 2.2-4-21](#); [45 IAC 2.2-4-22](#); [45 IAC 2.2-4-23](#); Sales Tax Information Bulletin 60 (July 2006).

Taxpayer protests the imposition of use tax on materials used in construction projects.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer. The Indiana Department of Revenue ("Department") conducted an audit for the tax years 2008 and 2009. Due to the volume of Taxpayer's records, the Department and Taxpayer agreed to utilize a sample selected from Taxpayer's records and a projection method to perform the audit. Pursuant to the audit, the Department determined that Taxpayer owed additional use tax. The Department found that Taxpayer had made a variety of purchases on which sales tax was not paid at the time of purchase nor was use tax remitted to the Department. Taxpayer disagreed with some of the audit results and protested. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Sales and Use Tax – Manufacturing Exemption.

DISCUSSION

Taxpayer asserts that certain of its purchases are not subject to use tax because the purchases would qualify for the manufacturing equipment exemption as found in IC § 6-2.5-5-3.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b). Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoades v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

Generally, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly, or finishing of tangible personal property are taxable. [45 IAC 2.2-5-8\(a\)](#). An exemption from use tax is granted for transactions where the sales tax was paid at the time of purchase pursuant to IC § 6-2.5-3-4. There are also additional exemptions from sales tax and use tax. A statute which provides a tax exemption, however, is strictly construed against the taxpayer. Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 97 (Ind. Ct. App. 1974). "Exemption statutes are strictly construed because an exemption releases property from the obligation of bearing its fair share of the cost of government." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991) aff'd 599 N.E.2d 588 (Ind. 1992) (Internal citations omitted). Thus, "[W]here such an exemption is claimed, the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." RCA, 310 N.E.2d at 100-101. Accordingly, the taxpayer claiming exemption has the burden of showing the terms of the exemption statute are met. General Motors, 578 N.E.2d 404.

IC § 6-2.5-5-3(b) states:

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it **for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added).**

Thus, the Legislature granted Indiana manufacturers a sales tax exemption for certain purchases, which are for "direct use in direct production, manufacture... of other tangible personal property." In enacting the exemption, the Legislature clearly did not intend to create a global exemption for any and all equipment which a manufacturer purchases for use within its manufacturing facility. "Fairly read, the exemption was meant to apply to capital equipment that meets the 'double direct' test." *Mumma Bros. Drilling Co. v. Department of Revenue*, 411 N.E.2d 676, 678 (Ind. Ct. App. 1980). The capital equipment "in order to be exempt, must (1) be directly used by the purchaser and (2) be used in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of tangible personal property." *Indiana Dep't. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 525 (Ind. 1983). "The test for directness requires the equipment to have an 'immediate link with the product being produced.'" *Id.* Accordingly, the sales tax exemption is applicable to that equipment which meets the "double direct" test and is "essential and integral" to the manufacture of taxpayer's tangible personal property. *General Motors*, 578 N.E.2d at 401. The application of Indiana's double-direct manufacturing exemptions often varies based on a determination of when a taxpayer's manufacturing process is considered to have begun and ended.

An exemption applies to manufacturing machinery, tools, and equipment directly used by the purchaser in direct production. [45 IAC 2.2-5-8\(a\)](#). Machinery, tools, and equipment acquired for "direct use in the direct production" is defined in [45 IAC 2.2-5-8\(c\)](#) as "manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process" that have "an immediate effect on the article being produced." Property has "an immediate effect" when it becomes "an essential and integral part of the integrated process which produces tangible personal property." [45 IAC 2.2-5-8\(c\)](#). [45 IAC 2.2-5-8\(d\)](#) excludes pre-production and post production activities by providing that "'direct use in the production process' begins at the point of first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its complete form."

[45 IAC 2.2-5-8\(g\)](#) further states:

"Have an immediate effect upon the article being produced": Machinery, tools, and equipment which are used during the production process and which have an immediate effect upon the article being produced are exempt from tax. Component parts of a unit of machinery or equipment, which unit has an immediate effect on the article being produced, are exempt if such components are an integral part of such manufacturing unit. The fact that particular property may be considered essential to the conduct of the business of manufacturing because its use is required either by law or by practical necessity does not itself mean that the property "has an immediate effect upon the article being produced". Instead, in addition to being essential for one of the above reasons, the property must also be an integral part of an integrated process which produces tangible personal property.

Additionally, [45 IAC 2.2-5-8 \(j\)](#) provides:

Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading.

Accordingly, tangible personal property purchased for the use in the production of a manufactured good is subject to sales and use tax unless the property used has an immediate effect on and is essential to the production of the marketable good. Thus, it is only the property that has an immediate effect on and is essential to the production that is directly used in the direct production of a marketable good and is exempt.

A. Transportation and Storage Equipment.

1. "Toyota Motor Credit."

Taxpayer claims that "Toyota Motor Credit" purchases qualify for a partial exemption from use tax under [45 IAC 2.2-5-8\(f\)\(2\)](#), which states that "[t]ransportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process." Taxpayer asserts that "all of the invoices listed for 'Toyota Motor Credit' are for lease or rental of forklifts that [Taxpayer] uses in the facility." Since the Department's audit applied [45 IAC 2.2-5-8\(f\)](#) to Taxpayer forklift usage and determined that Taxpayer's forklift usage was ten percent taxable, Taxpayer maintains that only ten percent of the "Toyota Motor Credit" invoices amounts should be subject to use tax as well.

During the hearing, Taxpayer's representative was asked to provide the invoices in question. However, Taxpayer has not provided documentation other than its own assertion that the invoices are for forklift rentals.

Since Taxpayer failed to provide documentation to support its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1. Therefore, the Department finds no reason to disagree with the audit's conclusion that these amounts are subject to use tax.

Accordingly, Taxpayer's protest to the imposition of use tax on one hundred percent of the amount from "Toyota Motor credit" transactions is respectfully denied.

2. "Pro-Lift Racks."

Taxpayer asserts that since it uses the "Pro-Lift racks" to store work-in-process, the racks qualify for the manufacturing equipment exemption. Specifically, Taxpayer states:

Taxpayer uses the racks to store all parts that [Taxpayer] has inspected to meet their customer's specifications. If the product does not meet specifications, [Taxpayer] either reworks the parts or must scrap the parts. The parts that [Taxpayer] inspects are not finished goods as they have not been packaged as required by [Taxpayer's] customers.

The Department notes that [45 IAC 2.2-5-8\(e\)](#) states in part:

Tangible personal property used in or for the purpose of storing raw materials or finished goods is subject to tax except for temporary storage equipment necessary for moving materials being manufactured from one (1) machine to another or from one (1) production step to another.

(1) Temporary storage. Tangible personal property used in or for the purpose of storing work-in-process or semi-finished goods is not subject to tax if the work-in-process or semi-finished goods are ultimately completely produced for resale and in fact resold.

(2) Storage containers for finished goods after completion of the production process are subject to tax.

(3) Storage facilities or containers for materials or items currently undergoing production during the production process are deemed temporary storage facilities and containers and are not subject to tax.

The Department also notes that [45 IAC 2.2-5-8\(i\)](#) states:

Testing and inspection. Machinery, tools, and equipment used to test and inspect the product as part of the production process are exempt.

—EXAMPLE—

Selected parts are removed from production according to a schedule dictated by statistical sampling methods. Quality control equipment is used to test the parts in a room in the plant separate from the production line. Because of the functional interrelationship between the testing equipment and the machinery on the production line and because of the product flow, the testing equipment is an integral part of the integrated production process and is exempt.

In the instant case, Taxpayer is inspecting its product after production is complete. This is not the type of testing and inspecting that is considered part of the manufacturing process. Testing and inspecting completed products to see if it meets customer specifications is a marketing activity. Unlike the "quality control testing equipment" in the example, provided in the regulation, that has a functional interrelationship with the machinery on the product line and the product flowing in production; Taxpayer's production process is not changed as a result of the testing. In fact, as a result of the testing, Taxpayer's product is either shipped to the customer or rejected. Therefore, the storage of the product after production to be tested for marketing purposes is not the storage of work-in-process.

Accordingly, Taxpayer's protest to the imposition of use tax on its "Pro-Lift Racks" is respectfully denied.

B. "Repair Parts for Manufacturing Equipment."

Taxpayer asserts that various items purchased from "Columbus Industrial Equipment," "Arrow Industries," and numerous other vendors are all "repair parts" used to repair production equipment. Taxpayer maintains, "[it] purchased the parts and charged them to an account that [it] uses to track [its] spare parts inventory." Taxpayer states that the Department's audit most likely subjected these items to tax because the items were in an account entitled "Maintenance—Tool Crib."

Pursuant to [45 IAC 2.2-5-8\(h\)\(2\)](#), "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, a part purchased for the equipment would be tax exempt to the extent that the equipment is exempt.

Therefore, Taxpayer's protest to the imposition of use tax on "repair parts" is sustained in part subject to the results of a supplemental audit. The file is to be returned to the audit Division. The Audit Division is requested to review the invoices, in addition to other information available to the Department, and make whatever adjustments it deems appropriate, taking [45 IAC 2.2-5-8\(h\)\(2\)](#) into account.

C. "Coolant Water System and Boiler Water System."

Taxpayer asserts that the payments made for the quarterly service contract covering the coolant water system and the boiler water system qualify for exemption under [45 IAC 2.2-5-8](#). In effect, Taxpayer asserts that the property furnished under the maintenance agreement would be considered a repair or replacement part for the coolant water system and/or boiler water system.

Pursuant to [45 IAC 2.2-5-8\(h\)\(2\)](#), "[r]eplacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment, are exempt from tax." Accordingly, a part purchased for the equipment would be tax exempt to the extent that the equipment is exempt.

Taxpayer has provided sufficient information to establish the maintenance agreement would be exempt to the extent that the "Coolant Water System and Boiler Water System" are exempt from sales and use tax.

Therefore, Taxpayer's protest to the imposition of use tax on "repair parts" is sustained in part subject to the results of a supplemental audit. The file is to be returned to the audit Division. The Audit Division is requested to review the invoices, in addition to other information available to the Department, and make whatever adjustments it deems appropriate, taking [45 IAC 2.2-5-8\(h\)\(2\)](#) into account.

FINDING

Taxpayer's protest to the imposition of use tax on one hundred percent of the amount from "Toyota Motor credit" transactions is respectfully denied, as discussed in subpart A(1). Taxpayer's protest to the imposition of use tax on its "Pro-Lift Racks" is respectfully denied, as discussed in subpart A(2). Taxpayer's protest to the imposition of use tax on "repair parts" is sustained in part subject to the results of a supplemental audit, as discussed in subparts B and C.

II. Sales and Use Tax—"Maintenance Agreements."

DISCUSSION

The Department imposed use tax on several transactions on which Taxpayer did not pay sales tax at the time of the retail transactions. Taxpayer asserts that it purchased various "maintenance agreements" that are not taxable in Indiana.

Again, The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

A. "RDC Maintenance Agreement."

Taxpayer asserts that the "maintenance agreement" from RDC is not subject to use tax because it transfers real property and not tangible personal property. Taxpayer maintains that "the RDC maintenance agreement... covers [Taxpayer's] dock which is permanently attached to [Taxpayer's] building. As such the agreement covers real property maintenance and is thus not a transfer of tangible personal property."

During the protest, Taxpayer's representative was asked to provide additional information and a copy of the "maintenance agreement" to establish the nature of the transaction. However, Taxpayer's representative did not provide any additional documentation for these transactions. Since Taxpayer failed to provide documentation to support its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1. Therefore, the Department finds no reason to disagree with the audit's conclusion that the transactions are subject to use tax.

Accordingly, Taxpayer's protest is respectfully denied.

B. Other Agreements.

Taxpayer asserts that a number of "maintenance agreements" it purchased are not taxable sales and use tax transactions because "there [was] no reasonable expectation that the purchaser will receive any tangible personal property."

During the protest, Taxpayer's representative was asked to provide copies of the "maintain agreements" establishing the nature of these transactions. However, Taxpayer's representative did not provide any additional documentation for these transactions. Since Taxpayer failed to provide documentation to support its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1. Therefore, the Department finds no reason to disagree with the audit's conclusion that the transactions are subject to use tax.

Accordingly, Taxpayer's protest is respectfully denied.

FINDING

Taxpayer's protest to the imposition of tax on "maintenance agreements" is respectfully denied.

III. Sales and Use Tax—Improvements to Realty.

DISCUSSION

The Department imposed use tax on several transactions on which Taxpayer did not pay sales tax at the time of the retail transactions. Taxpayer maintains that it engaged a contractor, on a lump sum basis, to perform a number of projects through the audit periods which Taxpayer considered improvements to realty. Again, The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Also, [45 IAC 2.2-3-4](#) provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Also of relevance is [45 IAC 2.2-4-21](#), which states:

(a) In general, all sales of tangible personal property are taxable, and all sales of real property are not

taxable. The conversion of tangible personal property into realty does not relieve a liability for any owing and unpaid state gross retail tax or use tax with respect to such tangible personal property.

(b) All construction material purchased by a contractor is taxable either at the time of purchase, or if purchased exempt (or otherwise acquired exempt) upon disposition unless the ultimate recipient could have purchased it exempt (see 6-2.5-5 [45 IAC 2.2-5]).

Also, 45 IAC 2.2-4-22 states:

(a) A contractor may purchase construction material exempt from the state gross retail tax only if he issues either an exemption certificate or a direct pay certificate to the seller at the time of purchase.

(b) A contractor, who purchases construction material exempt from the state gross retail tax or otherwise acquires construction material "tax-free", is accountable to the Department of Revenue for the state gross retail tax when he disposes of such property unless the ultimate recipient could have purchased it exempt (See 6-2.5-5 [45 IAC 2.2-5]).

(c) A contractor has the burden of proof to establish exempt sale or use when construction material, which was acquired "taxfree", is not subject to either the state gross retail tax or use tax upon disposition.

(d) Disposition subject to the state gross retail tax. A contractor-retail merchant has the responsibility to collect the state gross retail tax and to remit such tax to the Department of Revenue whenever he disposes of any construction material in the following manner:

(1) Time and material contract. He converts the construction material into realty on land he does not own and states separately the cost for the construction materials and the cost for the labor and other charges (only the gross proceeds from the sale of the construction material are subject to tax); or

(2) Construction material sold over-the-counter. Over the counter sales of construction materials will be treated as exempt from the state gross retail tax only if the contractor receives a valid exemption certificate issued by the person for whom the construction is being performed or by the customer who purchases over-the-counter, or a direct pay permit issued by the customer who purchases over-the-counter.

(e) Disposition subject to the use tax. With respect to construction material a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:

(1) He converts the construction material into realty on land he owns and then sells the improved real estate;

(2) He utilizes the construction material for his own benefit; or

(3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

A disposition under C. [subsection (e)(3) of this section] will be exempt from the use tax if the contractor received a valid exemption certificate from the ultimate purchaser (purchaser) or recipient of the construction material (as converted), provided such person could have initially purchased such property exempt from the state gross retail tax.

(Emphasis added).

Finally, 45 IAC 2.2-4-23 states:

A contractor has no further liability for either the state gross retail tax or use tax with respect to construction material acquired by the contractor in a taxable transaction, provided the contractor disposes of such property in the following manner:

1) He converts the construction materials into realty on land he owns and then sells the improved real estate;

(2) He utilizes the construction material for his own benefit and does not resell or transfer such property to others; or

(3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

(Emphasis added).

Accordingly, the fact that tangible personal property was incorporated into real property does not relieve a taxpayer of its obligation to pay sales or use tax. A contractor may convert tangible personal property into realty under a "lump sum contract" or under a "time and materials contract." Sales Tax Information Bulletin 60 (July 2006), 20060823 Ind. Reg. 045060287NRA, defines a "lump sum contract" as "a contract in which all of charges are quoted as a single price. A construction contractor may furnish a breakdown of the charges for labor, material and other items without changing the nature of the lump sum contract." A "time and materials contract" is defined as "a contract in which all charges for labor, construction materials and other items are separately stated." Id. Generally, in a lump sum contract between a taxpayer and its contractor, the contractor bears responsibility for paying the tax on the construction materials. In a time and materials contract between a taxpayer and its contractor, the contractor acts as a retail merchant and sales or use tax is due from the contractor's customers on the cost of the materials.

The Department's audit report contains several line items from various transactions with the contractor in question. The Department's audit report made notations where the information indicated the amount was for

materials only and subjected the amount to tax. The Department's audit report made notations where the information indicated that the amount was for labor only and did not subject the amount to tax. The Department's audit report also made notations that described transactions that would not appear to be considered improvements to realty and subjected those amounts to tax. Lastly, the Department's audit report, on one occasion, made a notation stating that the information indicated that that billing was under a lump sum contract and did not subject that amount to tax.

Taxpayer asserts that the Department's determination, that the materials only line item amounts are subject to tax, was not correct. During the protest, Taxpayer's representative was asked to provide documentation—i.e., invoices, contracts, and/or statements from the contractor—establishing the nature of these transactions. However, Taxpayer's representative did not provide any additional documentation for these transactions. Since Taxpayer failed to provide documentation to support its assertions, Taxpayer has failed to meet its burden to show that the assessment was incorrect under IC § 6-8.1-5-1. Therefore, the Department finds no reason to disagree with the audit's conclusion that these materials are subject to use tax.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer's protest to the imposition of use tax on "repair parts" is sustained in part subject to the results of a supplemental audit, as discussed in Issues I(B) and I(C). In all other respects, Taxpayer's protest is denied.

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